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IN THE

Supreme Court of the United States

OCTOBER TERM, 1967

No. 1180

HUNTINGTON TRUST & SAVINGS BANK,
a corporation,

Petitioner,

vs.

H. B. AGSTEN & SONS, INC.,
a corporation,
BERNARD L. BOUTIN, ADMINISTRATOR,
SMALL BUSINESS ADMINISTRATION, and
ODUS R. KINCAID and DELBERT E. WILLIAMS,
TRUSTEES,
WILLIAM H. MEINERS, d.b.a. GENERAL
FLOOR COMPANY,

Respondents.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fourth Circuit

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Petitioners pray that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Fourth Circuit entered on the 4th day of December, 1967.

Opinions Below

The United States District Court for the Southern District of West Virginia rendered no written opinion, but entered an order approving and confirming the report of George S. Wallace, Jr., special master to whom

the cause had been referred. The report of said special master is reproduced in the appendix to this petition. The opinion of the Court of Appeals has not yet been reported, but, together with the concurring and dissenting opinions, is reproduced in the appendix to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on December 4, 1967. It is believed that this Court has jurisdiction to review the judgment herein by Writ of Certiorari under 28 U.S.C. § 1254 (1).

Questions Presented

This case presents an issue as to the proper distribution of the proceeds from a judicial sale of real estate of an insolvent debtor as between three of its largest creditors: a contractor holding a mechanic's lien; a bank holding a deed of trust lien; and The Small Business Administration, an agency of the United States, also holding a deed of trust lien but claiming priority under the Federal Insolvency Statute, R. S. § 3466, 31 U.S.C. § 191. Under state law, the contractor's claim being prior in time, is superior to the claims of the bank and the SBA, and the bank's claim is likewise superior to the SBA, both in point of time and by specific agreement. Under federal law, the Federal Agency's claim is superior to the claim of the contractor, but by specific agreement is subordinate to the bank's claim. The questions presented are:

1. Does the Federal Insolvency Statute, R. S. § 3466, 31 U.S.C. 191, accord to debts due the United States absolute priority for payment out of the assets of an insolvent debtor irrespective of the existence of competing, specific, perfected and fully choate liens?

2. If so, does an agreement, made by The Small Business Administration, in furtherance of the purpose of the Small Business Act, to subordinate a lien securing a loan made by the SBA to a lien securing a loan made by a private bank, extend to such bank the benefit of the overriding priority accorded debts due to the United States under the Federal Insolvency Statute, R.S. § 3466, 31 U.S.C. 191?

3. If the Federal Insolvency Statute, R.S. § 3466, 31 U.S.C. 191, does not accord absolute priority to debts due the United States as against specific, perfected or choate liens, is the overriding priority of the Federal Insolvency Statute to be applied before or after the relative priorities of competing liens have been determined under state law?

4. If the bank's claim is entitled to priority over debts due the United States because of either an exception to or waiver of the priority created by R.S. § 3466, may the bank be required to satisfy in full out its recovery, a claim secured by a mechanic's lien which is inferior to debts due the United States?

Statutes Involved

The pertinent statutes are reproduced in the appendix to this petition.

Statement of the Case

West Virginia Industries Development Corporation, a West Virginia corporation, hereinafter called West Virginia, was the owner of thirty-one acres of land in Point Pleasant, West Virginia. After obtaining, on May 11, 1964, from the Area Redevelopment Administration, an authoriaztion for a loan to be made by The Small Business Administration, hereinafter

called SBA, in the sum of $1,042,500.00, it entered into a contract with H. B. Agsten and Sons, Inc., hereinafter called Agsten, for the construction on said land of a large motel. One of the conditions of said loan authoriaztion was that West Virginia should obtain an additional loan of funds from a non-governmental lender in the sum of $400,000.00, to be disbursed prior to or concurently with the SBA loan, which was to be subordinated to it. Although it was originally understood that the $400,00.00 loan would be made by Walston and Company, that loan did not materialize and the funds were eventually obtained on the same terms from Huntington Trust and Savings Bank, hereinafter called the Bank.

Construction of the motel was begun by Agsten on May 29, 1964. On September 22, 1964, West Virginia executed and delivered to the Bank a promissory note payable upon demand in the sum of $400,000.00 bearing six percent (6%) interest and secured the same by a deed of trust creating a lien upon the thirty-one acre tract, which deed of trust was the same day duly filed for record in the County Clerk's Office in accordance with state law.

On October 29, 1964, the SBA loan was carried into effect by the execution and delivery of West Virginia's promissory note in the sum of $1,042,500.00 bearing interest at the rate of four percent (4%) per annum, payable to SBA in installments, and secured by a deed of trust creating a lien upon said thirty-one acre tract of land, which deed of trust was duly recorded in the County Clerk's Office on October 30, 1964, in accordance with state law. This deed of trust contained a provision by which the same was made subject to and subordinate to a prior deed of trust securing a loan in the amount of $400,000.00. (The special master found

that this provision refers specifically to the Bank's $400,000.00 loan and this finding is not in dispute.) Thereafter, as construction proceeded, the Bank's loan was disbursed concurrently with the SBA loan on a pro rata basis in accordance with the ARA Loan Authoriatizon.

The motel was substantially completed in June, 1965, at which time West Virginia was insolvent. On August 30, 1965, Agsten filed in the County Clerk's Office a notice of mechanic's lien claiming a balance of $217,000.00 due on its contract and afterwards instituted this action in the Circuit Court of Mason County, West Virginia, to enforce its lien, naming as defendants West Virginia and all lien holders, including SBA and the Bank. SBA caused the action to be removed to the United States District Court for the Southern District of West Virginia which had jurisdiction because the United States was a party.

The special master, to whom the cause was referred, after finding that West Virginia was insolvent and in default in the payment of its indebtedness, determined the priorities for payment of claims against the real estate as follows:

> It is the opinion of the Special Master that the claim of Huntington Trust & Savings Bank of Huntington, West Virginia, in the amount of $412,607.00, with interest in the amount of $8,114.62 calculated to March 28, 1966, with additional interest in the amount of $68.78 per day until satisfied, shall be next after the payment of court costs and real estate taxes. However, out of this sum due the Bank shall be paid the amount due the Contractor, H. B. Agsten & Sons, Inc., P. O. Box 2707, Charleston, West Virginia, in the amount of $217,098.33, with interest in the amount of $8,445.17 calculated to

March 10, 1966, plus interest on the principal amount of $35,687 per day until satisfied.

The special master then found that next in priority was the indebtedness due SBA.

There are numerous other liens involved in this proceeding, but as they are all inferior to the liens of Agsten, the Bank and SBA, with the exception of certain mechanic's liens which are included in Agsten's claim, it is unnecessary to give further consideration to them.

The District Court approved and confirmed the findings of the special master and ordered the real estate of West Virginia to be sold. It was afterwards sold for the sum of $700,000 to SBA.

The effect of the priorities as established by the special master was to allow Agsten payment of its entire claim, the Bank less than one-half of its claim, with the SBA receiving the balance.

The Bank objects to the special master's findings establishing the priorities for payment as between Agsten, the Bank and SBA.

Reasons for Granting the Writ

1. This case presents an important question of federal law which this Court has never decided and which should be decided in this case. That question is whether the Federal Insolvency Statute, R.S. § 3466, 31 U.S.C. 191, creates an absolute priority for the satisfaction of debts due the United States from an insolvent debtor paramount to perfected, specific and choate liens on the debtor's property.

In the early decisions of *Thelusson* v. *Swift*, 2 Wheat 396, 426, 4 L.Ed. 271; *Conard* v. *Atlantic In-*

surance Company, 1 Pet. 386, 7 L.Ed. 189; and *Brent* v. *Bank of Washington,* 10 Pet. 596, 611, 612, 9 L.Ed. 547, an exception was read into the statute in the case of previously executed mortgages on the theory that mortgaged property is no longer part of the debtor's estate. Later decisions have by implication questioned the soundness of those early decisions. See *U.S.* v. *Texas,* 314 U.S. 480, 488, 62 S.Ct. 350, 354, 86 L.Ed. 356; *New York* v. *Maclay,* 288 U.S. 290, 53 S.Ct. 323, 72 L.Ed. 754. In any event, the Court has repeatedly said that the question of whether the priority of the United States under R.S. § 3466 would be defeated by a specific and perfected lien upon property where title and possession remain in the debtor has never been decided. In view of the fact that under West Virginia law, a deed of trust does not divest the debtor of title or possession, but creates a lien only, the question is here directly presented.

The resolution of this question is of vital importance to the effective administration of the Small Business Act, 15 U.S.C. §§ 631-651 which has as its purpose the encouragement and development of small business by the granting of federal loans and other assistance.

The Small Business Act contemplates the making of loans by banks and other non-governmental lending institutions in conjunction with loans to be made by the SBA, and its provisions evidence a purpose to stimulate, rather than to inhibit, the making of such private loans. The bank's loan in this case was made in conjunction with the SBA loan and, by agreement, the SBA loan was to be subordinate to it, both loans being made in furtherance of the purposes of the Small Business Act.

Congress, in enacting the Small Business Act, must have been aware that loans made by the SBA would

create debts due the United States and that in the event of the debtor's insolvency, R.S. § 3466, requires that such debts be first satisfied. Nothing in the Small Business Act indicates that Congress intended to except such debts from the operation of the Federal Insolvency Statute.

If a specific and choate lien will not defeat the priority accorded the SBA by R.S. § 3466, then as pointed out by Judge Bryan in his dissent from the opinion of the Court of Appeals, the making of a loan by SBA would immediately jeopardize and, in the event of the debtor's insolvency, completely destroy the security of every private lender. No private lender could ever be safe in such circumstances. To induce private banks to make such loans the SBA must place the bank in a position of priority. The Court of Appeals has held that the Bank is prior to SBA but not prior to Agsten. *Quaere*: Does the bank's priority rest upon federal law or state law? It is no answer to say that federal law gives the bank priority over SBA but state law takes it away since it is only by virtue of SBA's assertion of a federal law priority that the bank's recovery is put in jeopardy.

2. It is therefore also a matter of importance in the administration of the Small Business Act whether an agreement on the part of SBA to subordinate its position in favor of a private bank as an inducement for such private bank to make a loan to a small business is an extension of SBA's overriding priority to such private bank. And where such extension is effected, may the benefit thereof accrue to other private creditors who, under state law, enjoy a priority over such bank?

This matter was touched upon by this Court in

SBA v. *McClellan,* 364 U.S. 446, 81 S. Ct. 191, 5 L.Ed. 2d 200. In that case the SBA and the Bank made a joint loan, each putting up part of the loan funds, but the loan was made in the name of the Bank. After the debtor had been adjudicated a bankrupt, the bank assigned the loan to the SBA which agreed to pay over to the bank one-fourth of all amounts recovered. The Courts held:

> The SBA was authorized to enter into contracts calculated to induce private banks to make loans to small businesses. The contract involved in this case, by providing additional security to the private bank at the government's expense, is well adapted to that end.

The facts in this case are different in that the Bank and the SBA made separate loans but the SBA loan was expressly subordinated to the Bank's loan for the purpose of providing additional security to the Bank. The subordination agreement was an inducement for the Bank to make the loan and, it is therefore, in principle, not unlike the *McClellan* case. Although couched in terms of subordinating a lien in favor of a lien the subordination would be a meaningless gesture and a fraud upon the Bank unless it were held to be an extension of SBA's overriding priority under R.S. § 3466, otherwise, the assertion of that priority by SBA not only defeats the purpose of the subordination agreement, but penalizes the Bank for having dealt with SBA.

The Court of Appeals took the position that although such subordination is effective to give the Bank priority over SBA, federal law is not concerned with the ultimate disposition of the funds, that being a matter of state law.

The Court then held that state law requires the application of these funds first to the satisfaction of the claim of Agsten whose mechanic's lien under state law is prior to the Bank's deed of trust lien. As thus applied, state law is allowed to control and defeat an agreement made under the authority and in furtherance of the purposes of federal law, to wit, the Small Business Act. As a direct result of such holding, Agsten's claim, which enjoys no priority over SBA, is satisfied in full by the operation of state law, while the claim of the Bank, which was induced to make the loan on the strength of the priority extended to it under federal law, remains unsatisfied. The long range effect of this decision will be to handicap SBA in its efforts to induce private banks to make small business loans, and thwart the will of Congress.

3. The Court of Appeals failed correctly to distinguish between the priority arising from a lien and the priority created by the Federal Insolvency Statute. It treats R.S. § 3466 as if its sole purpose and effect is to convert SBA's inferior trust deed lien into a first lien. It therefore incorrectly treats the issue here presented as a circuity of liens caused by competing state and federal statutes, which is not the case at all. The only liens to be considered are: (1) Agsten's mechanic's lien; (2) the Bank's trust deed lien; and (3) SBA's trust deed lien. No federal lien statute is involved and as state law clearly establishes priorities as between the liens in the order listed above, no circuity of liens exists. The Federal Insolvency Statute injects an entirely different factor, which is not a lien but an overriding priority for satisfaction of debts due the United States irrespective of liens. The Federal Insolvency Statute does not create a lien; nor does it elevate an inferior lien securing debts due the United States to a position

of priority. It elevates the debt itself to a position of priority. *U.S.* v. *City of New Britain,* 347 U.S. 81, 74 S. Ct. 367, 98 L.Ed. 520. It is important that this distinction be made clear so that the proper relationship of federal and state law may be maintained. It is equally important that some rule be formulated as to the order of applying federal and state law where the results may differ, depending on which is first applied.

The Court of Appeals, following what is termed the "Federal Policy," i.e., that federal law determines the ultimate priorities of conflicting claims where a federal agency is involved, first applied the federal law and determined that SBA is superior to Agsten but inferior to the Bank. It then applied state law and determined that Agsten's claim is to be first satisfied out of the Bank's recovery. This solution fails to give the fullest effect to either federal or state law. It allows a claim, admittedly inferior to the federal claim, to be first satisfied contrary to federal law. It allows state law to override federal law by denying to the Bank the benefit of a priority accorded to it by federal law.

Since no federal lien is involved, it would seem the better reasoning to determine the priority as between the competing liens on the basis of state law without regard to federal law, and then apply the overriding priority of the Federal Insolvency Statute as against every claim which cannot withstand it. Thus, Agsten's claim would be entitled to a first lien priority under state law, but being unable to prevail against the Federal Insolvency Statute, the amount of Agsten's claim would have to be paid to the SBA. This would result, not from any failure to give effect to state lien

priorities, but solely from the superior force of federal law.

The Bank's claim should then be allowed a second lien priority under state law, subject also to SBA's overriding priority, but because SBA has expressly subordinated its position to that of the Bank, the Bank's claim must prevail against SBA and be satisfied in full.

This presents no conflict between state and federal law, but permits state law to operate within its proper sphere while giving full effect to the constitutional supremacy of federal law.

CONCLUSION

For the reasons stated, it is respectfully submitted that a Writ of Certiorari should be granted.

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APPENDIX

REPORT OF GEORGE S. WALLACE, JR. SPECIAL MASTER

APPEARANCES

For on behalf of parties to suit:

Mr. Hubard Ky Kloster meyer and Mr. William B. Maxwell, Attorneys for H. B. Agsten & Sons, Inc., Plaintiff.

Mr. Sidney S. McNeer, Jr., Attorney for the defendants Huntington Trust and Savings Bank, A. Grant Beckett, Trustee, and W. Kennon Cowden, Trustee.

Mr. W. Kennon Cowden, Trustee, in person.

Mr. George P. Beier, Assistant United States Attorney, appearing on behalf of the defendant Small Business Administration.

Mr. Julius R. Kincaid, Trustee, Small Business Administration, in person.

Mr. Edwin Slipek, Regional Counsel, Small Business Administration, Richmond, Virginia.

Mr. Edmund Hooker, Chief, Liquidation Division, Small Business Administration, Richmond, Virginia.

Mr. Guy Morris, Regional Director, Small Business Administration, Clarksburg, West Virginia.

Mr. Raymond G. Musgrave, Attorney for the defendant Carolina Lumber and Supply Company.

Mr. Paul M. Friedberg, Attorney for the defendant B & B Furniture Company.

Mr. H. L. Ducker, Attorney for the defendant Minter Homes Corporation.

Mr. Frank L. Taylor, Jr., Attorney for the defendant Andersons' Black Rock, Inc.